



The Finance Manager Course Notes

Effect of timing on revenues

A company recognizes revenue when it is realized, when it is earned, no matter when the firm receives the actual payment. Given that the payment for the product could have a different timing, we can easily end up with a difference between revenues and cash at hand. There are three possible options.



Cash before the sale

- If we receive 10,000 in advance, we'll use a T-account called "Prepaid Revenue". This is a liability and we'll credit it for 10,000
- When the goods have been delivered, we will credit the revenue account for 10,000 and will debit the prepaid revenue for 10,000.



Cash at the sale

- If we receive 10,000 in cash at the sale, we'll have to credit Revenues for 10,000 and debit Cash for the same amount.
- This option creates no difference between revenues and cash at hand, while the other two do.



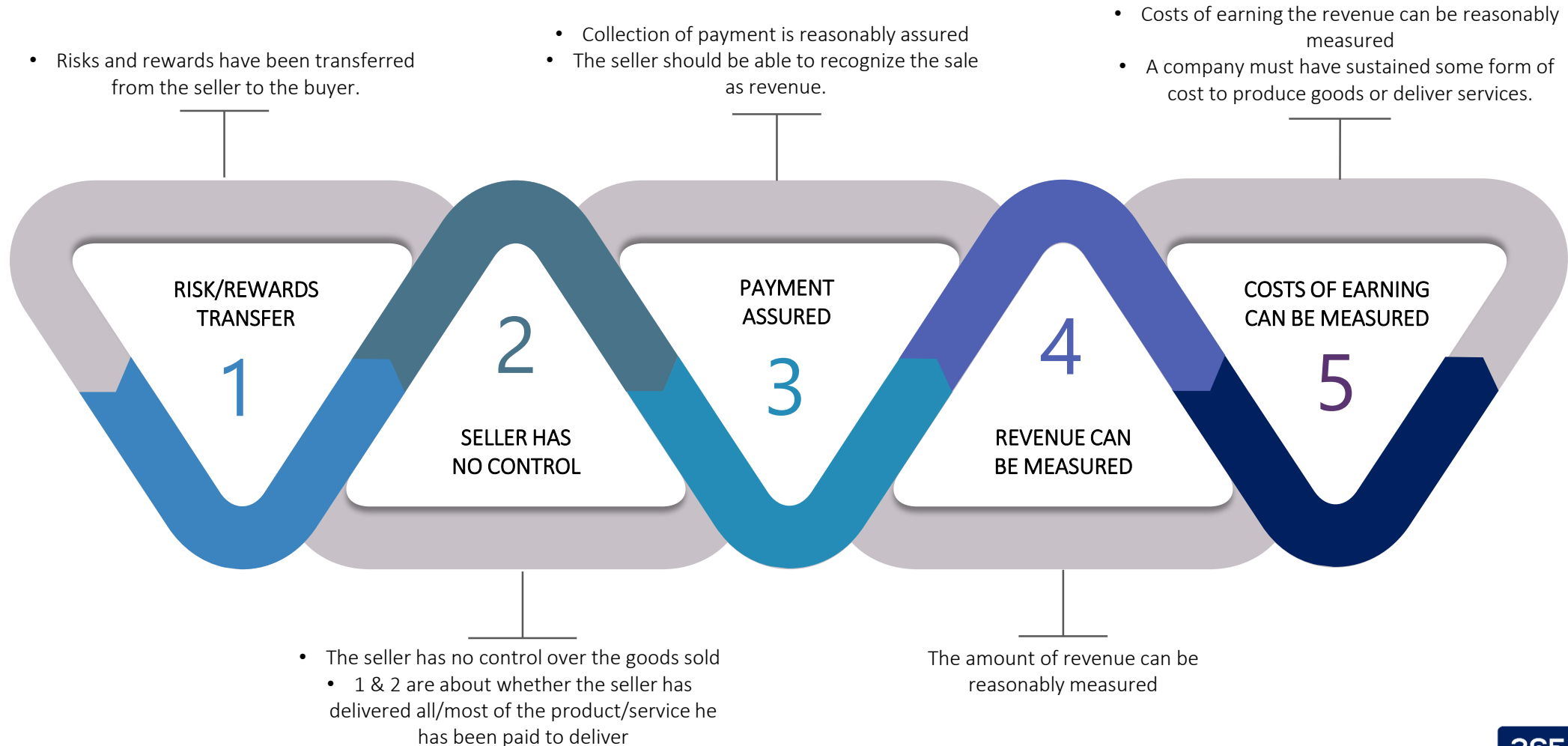
Cash after the sale

- We register 10,000 of revenue on the day when we deliver the goods.
- Instead of increasing our cash balance, we would have to increase its trade receivables account.
- We debit Trade Receivables for 10,000.
- Later, when the payment is received, we debit cash and credit trade receivables for 10,000.



Five criteria for revenue recognition

According to the International Financial Reporting Standards, revenue should be recognized when five criteria are met. CEOs and company management could be easily tempted to recognize some of their revenue early. This is why the five criteria are important.



Recognizing period costs

Expenses should be recognized in the P&L in the same period as revenues to which they relate.



The matching principle

- Once we register revenues in a period, we must register the respective costs in the same period too.
- This is known as the matching principle.



Period costs

- Certain types of expenses are more difficult to associate with revenue generation.
- Examples: operating expenses, such as accounting, admin personnel, and rent for office buildings,
- They are not directly tied with the sales the company makes.
- But these are costs that help the company create value.
- These expenses are designated as period costs and are charged to expense in the period they are sustained.

The two main P&L formats

Depending on the industry, there can be different variations, but the generic distinction we can make is there are two P&L formats: single and multistep.



SINGLE

- We say it is a single step because there are no intermediary results, such as Gross Profit and Operating income
- A single step P&L simply subtracts total revenues from total costs and gives us Net Income.



MULTISTEP

- A multistep P&L format allows us to see the difference between Revenues and Cogs – Gross Profit.
- It shows us Operating Income, which is not affected by items like interest expenses and extraordinary items.
- Most businesses prefer using this format as it is much more user friendly and easy to read.